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BEFORE THE

SENATE FINANCE SUBCOMMITTEE ON SOCIAL SECURITY

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Mr. Chairman:

The social security amendments enacted in December 1977 accomplished two major tasks. First, the procedure for indexing benefits was "decoupled," so the formula for determining the benefits of new retirees will no longer overcompensate for inflation. Second, the legislation provided for sufficient revenues to fund expected outlays in both the old age and survivors insurance (OASI) and the disability insurance (DI) programs over the next 40 years. These actions did much to reassure the public that the social security system would continue to be a dependable source of income for retired and disabled persons.

That financial soundness was achieved, however, through increases in the payroll tax rate (on both employers and employees) and in the covered earnings base. Under the new law, these increases start modestly for 1979. The average worker would pay only about $10 to $15 more in payroll taxes during 1979, although the 16 million workers earning more than the current maximum could find their payroll taxes increased as much as $260 in 1979.

By 1990 the tax rate in OASDI and the health insurance (HI) programs combined, will rise to 7.65 percent on employers and employees--a 19 percent increase over the pre-1977 law. By that year, the earnings base will rise to about $59,000 a year--a 33 percent increase over past law.

Two decisions mandated these large increases. The first was the acceptance of a benefit structure in which total benefit payments, even under the new decoupled benefit formula, are expected to rise significantly over the next 50 years (see Table 1). The second decision that made the payroll tax increases inevitable was the rejection of general revenue funding.

Since the 1977 amendments were enacted, concerns about the impact of the social security tax increases on both individuals and the economy have grown. One concern is that, in an economy not yet fully recovered from recession, tax increases could dampen consumer demand and employment. The Administration's proposal to cut personal and corporate income taxes by $25 billion in fiscal year 1979 was prompted in part by a perceived need to offset the dampening effects of the social security tax increases on the economy. Another concern, less easily offset by changes in other taxes, is that payroll tax increases may aggravate inflation at a time when prices are already increasing at far too rapid a rate.

PROPOSALS FOR CHANGE

In response to the concern over rising social security taxes, several Members of Congress have proposed legislation that would reduce the payroll tax and that could therefore be viewed as partial or full substitutes for the Administration's proposed income tax cut. Some of the proposed alternatives would reduce social security taxes considerably--even below the levels in effect before 1977--and would require significant permanent changes in the

way social security is financed. Others would simply maintain the system for a few years, until a solution to the difficult underlying problems of financing and the benefit structure could be found.

Simple Rollback to Pre-1977 Law

One temporary expedient is to roll back the tax rates and the taxable earnings base to what had been scheduled prior to the 1977 amendments. If no additional funds were made available, receipts would not be sufficient to cover outlays and the existing trust fund reserves would have to be used to make benefit payments. CBO estimates that the OASI and DI funds, even if combined, would fall to about $13 billion by the end of fiscal year 1981 and would probably be exhausted in fiscal year 1983. Because payroll tax receipts are highly sensitive to changes in the economy, the funds would be depleted sooner in the event of an economic downturn. A simple rollback would therefore leave the social security system in a vulnerable position.

Rollback with General Fund Transfer for HI

In testimony before the Senate Budget Committee on March 20, 1978, Senator Nelson proposed rolling back the total payroll tax rate (OASDI and HI) and the taxable earnings base to their scheduled levels before the 1977 legislation, while maintaining the financial positions of the three social security programs as they would be under current law, by shifting tax receipts from HI to OASDI. The HI trust funds would in turn be kept at the

levels they would have attained under current law by general revenue transfers. CBO estimates that about $4.6 billion would be required in general fund transfers in fiscal year 1979, with a cumulative total of $30.8 billion through fiscal year 1981. If no new legislation were passed by 1981, the provisions of the 1977 act would be implemented in 1982.

Eliminate DI and HI Taxes (the Nelson-Mikva Bill)

A more far-reaching proposal, introduced by Senator Nelson (S.2503) and Congressman Mikva, would finance the disability and hospital components entirely from general revenues and would eliminate the DI and HI taxes now levied on earnings. OASI tax rates would be slightly lower than under current law, but the earnings base would be the same. Major transfers from general revenues--$35 billion in fiscal year 1979 and $64 billion by fiscal year 1983--would be needed to keep the DI and HI programs at current law levels.

One-Third General Revenue Financing (the Hathaway-Burke Bill)

Another far-reaching proposal, introduced by Senator Hathaway (S.2501) and Congressman Burke, would lower payroll tax rates in OASDI and HI considerably, but it would raise the annual earnings level on which taxes and benefits are based to $100,000 in 1979 and would index the level thereafter. The federal government would insure that total revenues into the social security trust funds equal 150 percent of the amount collected in payroll taxes, thus ensuring that one-third of the total trust fund income would be derived from general revenues.

The Hathaway-Burke bill would require higher revenues, partly because the higher maximum results in a higher level of future outlays and partly because the bill stipulates that the OASDI system must be balanced fully over the next 75 years, whereas the other plans imply likely deficits after about the year 2020. As a result, larger OASDI trust fund reserves would be accumulated under the Hathaway-Burke bill than under current law. The Hathaway-Burke bill would require a transfer from the general fund of $45 billion in fiscal year 1979 and $66 billion by fiscal year 1983.

Tax Credits

An alternative method of reducing the burden of increases in social security taxes is to allow a refundable credit against personal income taxes for a portion of social security tax payments. A refundable credit of 10 percent of only the employee and the self-employed social security tax liability would reduce income tax receipts by $6.5 billion in fiscal year 1979.

Such a credit against income taxes formally retains equal rates and wage bases for both employer and employee while effectively reducing the tax burden on employees and providing indirect general revenue funding.

Social security tax rates and the tax base for the next five years, under current law and under the several alternatives for reducing social security taxes, are shown in Table 2. Tables 3, 4, and 5 show the effects of these changes on payroll tax receipts, on required transfers from the general fund, and on trust fund balances.

The various alternatives for reducing the burden of the payroll tax differ from each other and from the President's tax cut proposal, in terms of their distributional effects, their effects on employment and prices, and their long-term implications for the finances and benefits of the social security system. I will discuss each of these considerations in turn.

DISTRIBUTIONAL IMPACTS

The fraction of workers whose earnings fall below the taxable maximum has risen steadily since 1965. By 1981, under current law, 94 percent of covered workers will have all of their earnings below the taxable maximum (see Table 6). These increases in the tax base have converted the social security tax from a regressive tax on earnings to a more nearly proportional tax on the earnings of covered workers.

The social security tax is not proportional, however, when calculated as a percent of total family income, which includes transfer income, property income, and income from other sources. Because earnings account for a relatively small proportion of the income of lower-income families (transfer income is important for them), OASDHI taxes rise as a proportion of income from the low to middle ranges of family income, remain at a roughly constant proportion through the middle, and decline at the top, where property income becomes more important and a larger fraction of earnings exceed the taxable maximum (see Table 7).

By contrast, the federal income tax is a steadily progressive tax throughout the income distribution. Hence changes which result in a substitution of income tax revenues for social security tax revenues tend to increase the progressivity of the federal tax system.

The focus of attention at the moment, however, is not so much the effect of substituting one kind of tax for the other as the contrast between the effects of alternative tax cuts on various income groups. Table 8 compares the effects of alternative tax cuts on families at different income levels.

The Nelson-Mikva bill for eliminating HI and DI taxes and the refundable 10 percent credit would both result in equal percentage reductions in social security taxes across the board. About 18 percent of the tax relief under these bills would go to families with incomes under $15,000 a year; 32 percent would go to families with incomes between $15,000 and $25,000; and 50 percent would go to those with incomes over $25,000.

The Hathaway-Burke proposal for one-third general revenue financing, which reduces tax rates but raises the earnings base, would benefit lower-income families more than an across-the-board reduction in employee payroll tax liabilities. Under the Hathaway-Burke bill, 25 percent of the tax relief would go to families with incomes under $15,000 a year and 31 percent would go to those with incomes over $25,000. This higher income group includes the 4 percent of all families with incomes above $50,000

a year, who would actually pay more taxes under the Hathaway-Burke bill. Conversely, the Nelson proposal to roll back both the tax rates and the tax base to their pre-1977 levels would benefit those at the higher end of the income distribution relatively more, because these groups had the greatest increase in their tax burden under the 1977 amendments.

A comparison of the effects of the various social security tax reduction proposals with the Administration's proposed income tax cut is shown in Table 9. Data giving the effects of the President's tax cut on families classified by their total income are not available. As an expedient, Table 9 uses currently available information that gives distributions for individuals and couples filing income tax returns. 1/

The Administration's tax reduction, with reforms, is more skewed toward the lower- and middle-income tax filing units than any of the social security tax reductions, except for the

1/ Because Table 9 shows the distribution of income for tax filing units rather than for families, the percentages in each income class are not the same as in Table 8. For example, the tax filing unit data include as separate units many young people and others filing tax returns who are classified as low-income, although they may be members of higher-income families. This and the fact that the data refer to 1977 income levels account for the inordinately large percentage shown in Table 9 as having incomes below $5,000. In addition, the two sets of data also use different definitions of income. Despite these differences, the tables tell the same general story with respect to the comparative effects of the different proposals.

Hathaway-Burke bill. Without the reform, the Administration's proposal is somewhat more generous to the upper part of the income range than an across-the-board reduction in social security tax payments would be (Nelson-Mikva or the refundable tax credit), but less so than the Nelson proposal for a rollback of the OASDHI rates and base to their pre-1977 levels.

The distributional effects of the various proposals can, of course, be compared in many ways. I am attaching a supplement that contains tables giving more detailed information.

In evaluating the distributional impact of the various alternatives, two caveats should be kept in mind. First, the proposals are distributing very different total amounts of tax relief. Presumably, the social security proposals that reduce tax revenues by relatively small amounts could be combined with an income tax cut. The net effect on the income distribution would then be the average of the two kinds of reductions.

Second, our analysis refers only to the employee and self-employed portion of the social security tax. The eventual distribution of the employer's share of the tax, which is nearly as large, is very difficult to determine. If the major impact of that reduction is to lower prices, then consumers in general, including those who pay no social security taxes, would benefit according to their expenditures, which in turn are roughly distributed proportionally with income. If, however, a reduction

in the employer share ultimately resulted in an increase in the wages of covered employees, then the distribution of the employer share would be much like that of the employee share.

AGGREGATE ECONOMIC EFFECTS

A major argument for the Administration's proposal for cutting personal income taxes is that economic growth is likely to slow significantly, if measures are not taken to offset the dampening effects of legislated increases in social security taxes combined with the automatic increases in effective federal income tax rates that are induced by inflation. Although a reduction in income taxes can stimulate demand, unlike a reduction in social security taxes, it cannot reduce inflationary pressures.

A reduction in the employee share of social security taxes would directly increase the take-home pay of workers, which in turn would raise overall demand. The reduction in the employer share of the payroll tax operates in a more complicated way. Payroll taxes are a cost of production and, as such, are likely to be at least partially reflected in the prices of goods produced. Initially, a reduction in this tax may increase profits. But, as firms try to expand sales, competition, combined with reduced costs, can be expected to contribute to a moderation in price increases--a one-time moderation occurring over the year or so following the tax cut. In the long run, wages might also be bid up, as firms attempt to expand and increase their work forces. By reducing

the rise in the price level, or by raising wages, the cut in the employer share of the social security tax would also increase purchasing power and would then serve as an additional stimulant to economic activity.

CBO estimates that if a large part of the employer share of the tax were passed on in the form of lower prices, a $10 billion decrease in the payroll tax could be expected to lead to a reduction in the price level of two-tenths of a percentage point after about a year. The proposal to roll back the tax increase scheduled for 1979 would keep taxes from rising by $3.5 billion and would therefore be expected to prevent an increase in the price level of less than one-tenth of a percentage point.

The Hathaway-Burke and Nelson-Mikva bills reduce payroll taxes by $35 to $36 billion in calendar year 1979; they are estimated to reduce the rise in the consumer price index by one-half to three-fourths of one percentage point during the first year after enactment (see Table 10). The Administration's tax proposals have a slight net negative effect on prices, because the inflationary effects associated with increased growth would be roughly offset during the first year by the favorable price effects that would result from the proposed reduction in unemployment insurance taxes and in telephone excise taxes.

The two social security tax reductions are greater in magnitude and so would eventually produce a greater stimulus to output and employment than the President's proposed tax reduction.

Dollar for dollar, however, the first full-year effects are expected to be quite similar.

CBO is not able to distinguish different employment and price effects among the various proposals to cut payroll taxes for both employers and employees, except insofar as the differences relate to the size of the tax changes. However, since the proposal for a 10 percent refundable tax credit for employees and the self-employed would leave the payroll tax burden on employers unchanged, production costs and prices would not be directly affected. This proposal would have stimulative effects on economic activity similar to a personal income tax cut.

LONG-TERM ISSUES

In the short run, payroll taxes could be reduced by significant amounts without raising general tax rates. Substituting the Hathaway-Burke bill for the Administration's proposed income tax cuts would increase the federal deficit in fiscal year 1969 by $3.6 billion; substituting the Nelson-Mikva bill would raise it by $9.8 billion (see Table 11). (By fiscal year 1980, each would add $13 billion more to the federal deficit than would the Administration's proposed cut.)

In the long run, however, both these social security tax reduction proposals imply considerably larger losses in federal revenues than the President's tax proposal. By 1983, under both proposals, the payroll tax losses would be around $70 billion more than current law as compared with $35 billion under the President's proposal. Revenue losses of this magnitude mean that in the future

there will be substantially less room in the budget for spending increases than there would otherwise have been, or effective tax rates may have to be allowed to rise.

Choosing between the payroll tax and the income tax as a source of funding for social security involves not only the question of whether the income tax has more desirable economic and distributional consequences than the payroll tax but also the implications of general revenue funding for social security.

Opponents of general revenue funding for social security argue that such indirect financing would inevitably lead to program expansion, inasmuch as the true cost of benefit liberalization would be obscured if benefit increases were not explicitly tied to tax increases. Furthermore, they argue it would weaken the insurance nature of the program, through which individual workers earn the right to benefits through work in covered employment. (Since the value of the HI benefit is not directly tied to past contributions, this argument may be less persuasive for the medicare program.) Retired beneficiaries may fear that, by cutting the tie between contributions and benefits, general revenue financing could lead to the introduction of a needs test for benefits.

There is another alternative to raising payroll taxes that would avoid the use of general revenue funding--that is, social security benefits could be restructured so that future costs do not increase as rapidly as they are now scheduled to do. This could be done by limiting benefits for specific categories of future beneficiaries or by an overall modification of the benefit structure. Table 12 shows the differences in social security

costs under a few illustrative options for reducing benefits. Changes in the benefit structure would, of course, require more detailed study and analysis.

Unfortunately, the choices for financing social security in the long term are very difficult to make. Even the increases in payroll taxes scheduled under current law are not likely to be sufficient to provide funds to cover outlays much beyond the year 2020. Ultimately, then, the choice must be made between raising taxes--whether income or payroll taxes--and providing for a lower level of benefits. The implications of this basic choice should be debated carefully over the next few years.

TABLE 1. ESTIMATED OASDI OUTLAYS AS A PERCENT OF TAXABLE PAYROLL AND OF NATIONAL INCOME

Calendar Year	Expenditures as Percent of Taxable Payroll	Expenditures as Percent of National Income
1977	10.9	5.6
1978	10.9	5.6
1979	10.3	5.3
1980	10.1	5.2
1990	10.6	5.4
2000	10.7	5.6
2010	12.2	6.2
2020	15.0	7.7
2030	17.1	8.8
2040	16.7	8.6
2050	16.2	8.3

SOURCE: Social Security Administration and CBO estimates.

TABLE 2. OASDHI TAX RATES AND TAXABLE EARNINGS UNDER ALTERNATIVE FINANCING PLANS, CALENDAR YEARS 1979-1983

Calendar Year	Employer and Employee Rates, Each: OASI	DI	OASDI Combined	HI	OASDHI	Taxable Earnings Base*
Current Law						
1979	4.330	.750	5.080	1.050	6.130	22,900
1980	4.330	.750	5.080	1.050	6.130	25,900
1981	4.525	.825	5.350	1.300	6.650	29,700
1982	4.575	.825	5.400	1.300	6.700	32,100
1983	4.575	.825	5.400	1.300	6.700	34,800
Prior to 1977 Act						
1979	4.350	.600	4.950	1.100	6.050	18,900
1980	4.350	.600	4.950	1.100	6.050	20,700
1981	4.300	.650	4.950	1.350	6.300	22,200
1982	4.300	.650	4.950	1.350	6.300	24,000
1983	4.300	.650	4.950	1.350	6.300	26,100
Rollback with general revenue transfer to HI						
1979	5.300 1/	--	5.300	.750	6.050	18,900
1980	5.400 1/	--	5.400	.650	6.050	20,700
1981	5.750 1/	--	5.750	.550	6.300	22,200
1982 1983	(If no new legislation passed, revert to current law)					
One-third general revenue funding (S.2501, HR 10668)						
1979	3.200 1/	--	3.200	.700	3.900	100,000
1980	3.200 1/	--	3.200	.700	3.900	109,000
1981	3.250 1/	--	3.250	.750	4.000	118,000
1982	3.250 1/	--	3.250	.750	4.000	127,000
1983	3.250 1/	--	3.250	.750	4.000	138,000
Elimination of DI and HI taxes (S 2503, HR 10754) 2/						
1979	4.330	--	4.330	--	4.330	22,900
1980	4.330	--	4.330	--	4.330	25,900
1981	4.400	--	4.400	--	4.400	29,700
1982	4.400	--	4.400	--	4.400	32,100
1983	4.400	--	4.400	--	4.400	34,800

*Automatic increases based on CBO economic assumptions.

1/ OASI and DI combined.

2/ DI and HI revenues will be entirely from General Revenues.

TABLE 3. SOCIAL SECURITY REVENUES a/ UNDER CURRENT LAW AND CHANGES UNDER ALTERNATIVE PROPOSALS, FISCAL YEARS 1979-1983, IN BILLIONS OF DOLLARS

Fiscal Year	Revenues Under Current Law	Change in Revenues From Current Law Under: Roll Back to Pre-1977 Law	Rollback With General Fund Transfer to HI (Nelson)	One-Third General Revenue Funding (S. 2501, H. R. 10668)	Elimination of HI and DI Taxes (S. 2503, H. R. 10754)
1979					
OASDI	100.0	-4.2	+1.4	-24.5	-14.8
HI	20.2	+.8	-4.6	-4.4	-20.2
OASDHI	120.2	-3.4	-3.2	-28.9	-35.0
1980					
OASDI	114.4	-8.7	+.3	-34.1	-16.6
HI	23.4	-.2	-9.1	-6.2	-23.4
OASDHI	137.8	-8.9	-8.8	-40.3	-40.0
1981					
OASDI	132.1	-15.5	+1.1	-42.8	-22.0
HI	30.5	-.6	-17.1	-10.6	-30.5
OASDHI	162.6	-16.1	-16.0	-53.4	-52.5
1982					
OASDI	150.5	-22.0	--	-51.5	-27.6
HI	35.8	-1.2	--	-13.6	-35.8
OASDHI	186.3	-23.2	--	-65.1	-63.4
1983					
OASDI	165.6	-24.5	--	-57.0	-30.7
HI	39.3	-1.2	--	-14.6	-39.3
OASDHI	204.9	-25.7	--	-71.6	-70.0

SOURCE: CBO estimates.

a/ Revenues include net payroll tax receipts and federal employee contributions; general revenue and interest income are excluded.

TABLE 4. TRANSFERS FROM GENERAL REVENUES REQUIRED FOR OASDHI TRUST FUNDS UNDER ALTERNATIVE FINANCING PROPOSALS, BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	Alternative		
Fiscal Year	Rollback With General Revenue Transfers to HI	One-Third General Revenue Funding (S. 2501, H. R. 10668)	Elimination of HI and DI Taxes (S. 2503, H. R. 10754)
1979	4.6	45.2	34.8
1980	9.1	48.3	39.8
1981	17.1	54.1	50.0
1982	--	60.2	58.3
1983	--	66.1	64.0
Cumulative, 1979-1983	30.8	273.9	246.9

SOURCE: CBO estimate

TABLE 5. TRUST FUND BALANCES AT THE END OF FISCAL YEARS 1979-1983 UNDER ALTERNATIVE FINANCING PLANS: IN BILLIONS OF DOLLARS

Fiscal Year	Current Law	Rollback to Pre-1977 Law	Rollback With General Revenue Transfers to HI	One-Third General Revenue Funding (S 2501) HR 10668)	Elimination of DI and HI Taxes HR 10754, S 2503
1979					
OASDI	33.9	29.6	34.8	46.3	33.9
HI	12.7	13.5	12.7	15.9	12.7
OASDHI	46.6	43.1	47.5	62.2	46.6
1980					
OASDI	35.5	21.8	36.7	54.2	35.8
HI	13.8	14.5	13.8	19.5	13.8
OASDHI	49.3	36.3	50.5	73.7	49.6
1981					
OASDI	43.2	12.6	45.6	64.3	41.6
HI	18.4	18.4	18.4	23.7	18.4
OASDHI	61.6	31.0	64.0	88.0	60.0
1982					
OASDI	58.0	2.6	60.6	77.5	51.6
HI	24.3	23.1	24.3	27.6	24.3
OASDHI	82.3	25.7	84.9	105.1	75.9
1983					
OASDI	75.8	-8.7	78.6	92.5	63.7
HI	29.2	26.6	29.2	30.2	29.2
OASDHI	105.0	17.9	107.8	122.7	92.9

SOURCE: CBO estimates.